

February 1998

ASIAN CRISIS THEMES

Rudi Dornbusch

Massachusetts Institute of Technology

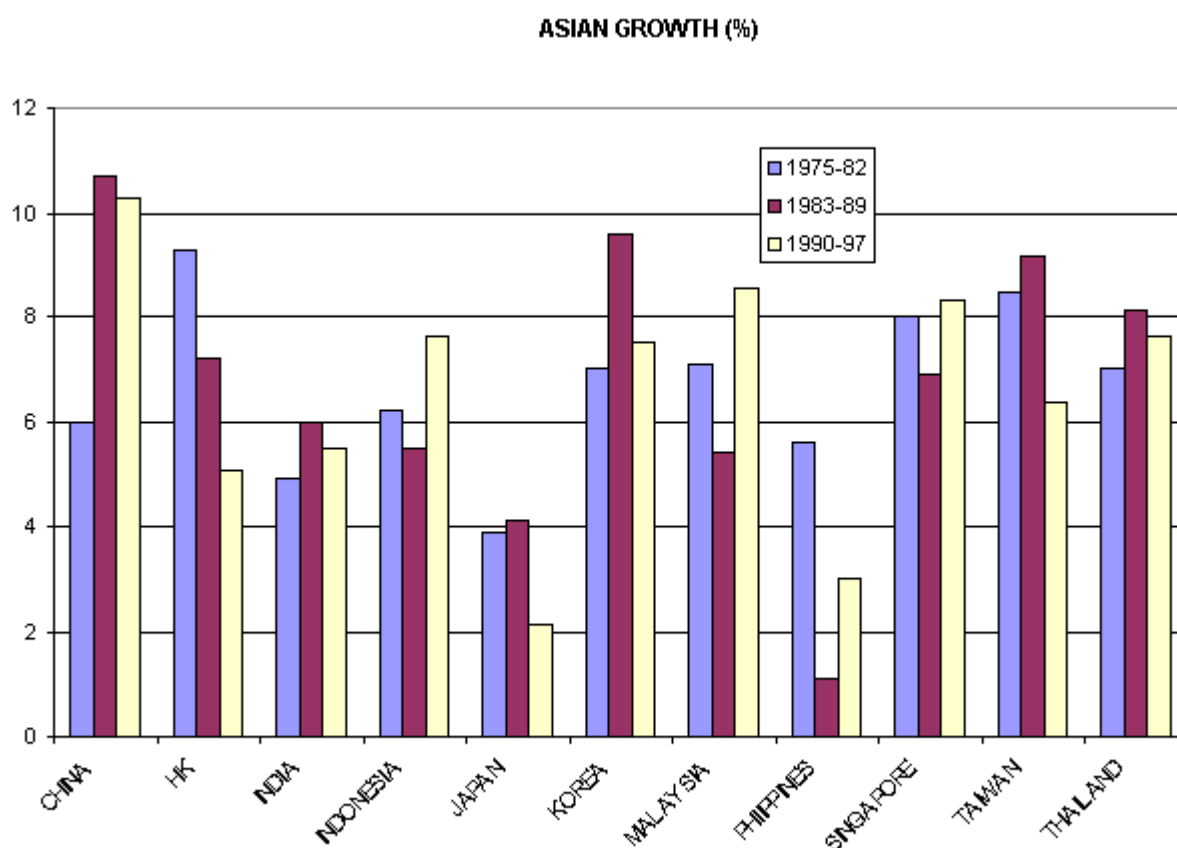
In asset and exchange markets, outside Indonesia, the Asian crisis is mostly over. The various crisis countries are into reconstruction which is, of course, a very demanding and politically tough agenda. But considering the extent of meltdown of currencies and stock markets, the expected impact on real activity this year and next is rather moderate. In 1995 Latin America's growth rate fell to zero with the numbers for Argentina -5 percent and -6.6 percent in Mexico. By contrast, although there are important divergences across forecasters and countries, the Asian impact is decidedly smaller and that is even the case when China is left out. This is important to bear in mind because any notion that 20 years of progress has been destroyed in just a few months is simply nonsense. There has been a lot of damage on paper, and to credit, but the real economies are not only still there but some may even grow this year.

Table 1 Asian Growth Outlook for 1998 and 1999 (1999 forecast in brackets)					
	Goldman	JPMorgan	SBC	Nomura	ING
China	9.0 (8.6)	7.5 (7.4)	7.0 (8.5)	9.0	6.7 (7.1)
HK	2.0 (5.0)	2.0 (3.3)	3.0 (4.0)	4.1	4.0 (5.3)
Indonesia	0 (4.0)	-1.5 (4.0)	-2.9 (1.0)	2.2	1.8 (4.3)
Korea	1.2 (3.4)	-2.0 (3.5)	0.7 (2.6)	1.0	2.9 (3.3)
Malaysia	2.5 (4.0)	3.5 (-1.0)	1.5 (2.0)	1.9	3.7 (5.6)
Philippines	2.5 (4.0)	1.6 (4.1)	1.1 (3.0)	4.1	0.4 (4.2)
Thailand	-1.5 (2.5)	-2.5(2.5)	-1.8 (2.4)	-2.0	-3.9 (4.5)

The Mexican disaster of 1995 was V-shaped—a deep output drop in 1995 (-6.6%), a recovery in

1996 (5.2%) and expansion in 1997 (7.0%). Is that the blue print for Asia? Clearly Mexico was special in that much of the credit issue was in the public sector, but Mexico did and continues to have dramatic banking and balance sheet issues from exchange depreciation. Mexico also did not reverse any of the earlier liberalization and reform and that brought points. Finally, the assumption of a US umbrella and a close monitoring of policies helped assure confidence. What are the parallels in Asia?

FIGURE 1 HISTORICAL ASIAN GROWTH RATES/



Korea is the clearest case. In the past Korea desperately wanted to become like Japan and unfortunately succeeded. Nothing could be more pronounced than the post crisis recognition that the crisis was an opportunity for deep change. The new President calls the tune even before being officially in charge. He is not from the establishment. Deep structural; reform, from opening of the capital account to a role for share holders and banking reform are coming on, investment banks world the same side of the street helping refloat the country's credit, the IMF and the Treasury, needful of a good example, kept cheering and so does the stock market. Clearly, Korea will emerge from the crisis as a far better functioning economy.

Thailand is also doing most things right. Unlike in Korea, there is politics in Thailand and that complicates the decisiveness of an IMF program and the extent to which confidence of creditors

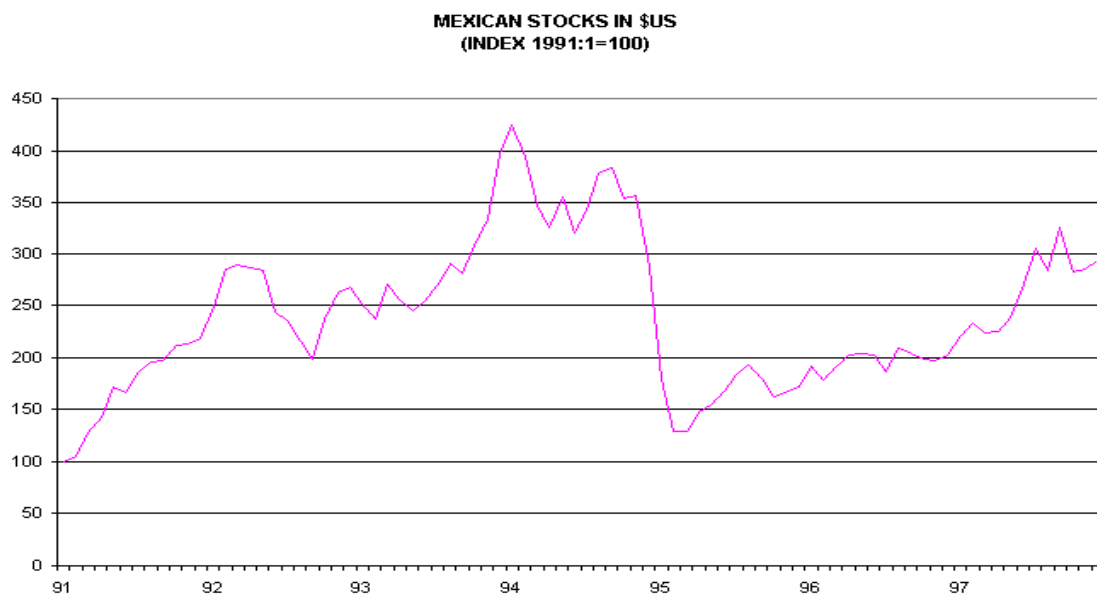
can rebound. But clearly Thailand is on the right track and despite the downturn in the current year, will have relatively little downtime.

Malaysia and the Philippines were not drawn into meltdown: the latter became a reform economy too late to get a lot of the magic potion. As a result, balance sheet effects and the credit squeeze were relatively small. Malaysia by contrast was financed predominantly by direct investment and for that reason avoided the more extreme meltdown experienced in countries where capital flight was a multiple of reserves. Not having the banking and credit collapse still leaves pressure but it is, of course, much less. Predictably, these countries won't even have a recession.

Hong Kong is perhaps the most interesting case: no recession here even though the stock market got hammered. Good banks and a hard currency can stand up to a storm. There is an extraordinarily important lesson here for Eastern Europe and Latin America.

The Asian crisis is not over without being sure as to what China will do. If China were to devalue there would surely be major repercussions and not in the least, second helpings of currency collapse and stock market collapse. The essay section argues that China will not devalue but it also is more pessimistic than the forecasts in Table 11 above.

The fact that asset markets are rebounding needs to be put in some perspective: even after a while, with confidence and credit restored to the point of free access to capital and a lengthening of maturities, there is no presumption that capital markets will not return to their previous heights. The accompanying figure shows the case of Mexico where the valuation of 1994 is still not recovered.



The unresolved issue in Asia is Indonesia. President Suharto is divided between saving his country or his children. He seems to be leaning in the latter direction, flirting with a currency board so that they can get their hands on the central bank reserves. The key issue today is to restore credit – reform the banks so that they can function rather than being under a complete

cloud of bankruptcy, resolve the external debt, and stabilize the currency by creating assurances that there will not be uncontrolled money growth. A currency board might be a useful component of the whole package but no more than that. Unless the complementary measures are taken, it is just a way of blowing away reserves.

Indonesia has a large range of possible outcomes: hyperinflation, military coups, muddling through and even, barely conceivable, a quick successful turn of events. At present the worst is well within the range of likely outcomes.

THAI RETROSPECTIVE

There must be lessons from the Thai debacle. Over and beyond the sheer fun of pointing fingers, there is the interesting question of how something can reach meltdown proportions and yet, a few months back, it was barely a problem and surely not a disaster in the making and around the corner.

A first look at the Thai economy would hardly raise suspicion. This is a strong growth economy, Asian-style, with negligible inflation, very conservative fiscal policy -- budget surpluses for a decade--, a very high saving rate. If economies like that get into trouble, woe to Latin America. The only spot of trouble is, of course, the very large current account deficit. True, it is an investment deficit but even so it raises questions of sustainability. The fact that it has been there all along is some comfort, but not enough.

Table 2 Thai Macro Performance				
	1981-90	1991-95	1995	1996
Growth	7.9	8.5	8.7	6.7
Inflation	4.4	4.8	5.8	5.9
Saving	26.2	34.8	35.0	35.3
Budget		3.4	1.5	1.5
Curr. Acc't		-6.9	-7.6	-7.5
Ext. Debt		48.1	68.1	78.1

Note: Saving, budget and current account
--

The real exchange rate, similarly, did not present an alarming situation. True, there had been some real appreciation-- about 15 percent over the past few years. But that compared very favorably to Latin experiences where the numbers are easily twice that much. The point then is that on a first pass, Thailand was not obviously the basket case that it is now and much less so than Mexico in 1994 -- in Mexico, there had been no growth, there had been a vast real appreciation, investment was negligible. The Thai situation also sported very large reserves, to start with, and that meant a speculative attack would not come easily. By April 1997, none (or few) of the regular financial reports had Thailand on the list for an outright debacle. More was needed.

The Thai problem, like that of Mexico, was *vulnerability*. Vulnerability means that if something goes wrong then suddenly a lot goes wrong. The situation emerges from the combination of a very shaky banking system made more shaky by the dollar debts of its clients, a very large and short-dated foreign debt with the resulting risk of a funding crisis a total lack of transparency and a pervasive overlay of corruption. In Thailand, almost every politician or official had his hands in the pocket of some bank or business and every bank had a lot of officials in its pocket. The outward manifestation of the domestic financial crisis was the real estate bubble and bust, but the unresolved issue was, of course, the question of what balance sheets really looked like, who was bust and who would be rescued by the government. No volunteers for transparency.

In a situation like that, there is not much room for waves. The Bank of Thailand could not raise interest rates to support the external financing without making the loan problems worse. And it could not reduce interest rates without making the risk of an external funding crisis worse. It might have cleaned up the banking system long ago, ensured covering of external dollar debts and shifting to a band-basket-crawl (BBC) exchange rate regime. All of that would have diffused the ingredients for crisis. But with too much macho, too much politics and a fair share of provincialism it never happened. In the end, "this country is different" is nonsense; by the time the crisis comes it looks surprisingly like the other ones. The decision in May to cut interest rates made it a free gamble to bet against the Bhat. Appreciation was out, depreciation was plausible the cost of carry turned against the country, *tally-ho!* The central bank, encouraged by the illusion of a strong reserve position took on vast bets and lost. Capital controls added a new wrinkle to the story, but not enough to change the outcome. Had they been used as the bridge to an immediate and substantial IMF program and financial work out all might have turned out well. But the window provided by controls were used for nothing and hence their unsustainability reinforced the meltdown.

Among the plausible insights to be gained from this experience, and the Mexican before, are these:

- *Of six crises predicted by experts, five never happen.* The sixth, however, does happen is far bigger than expected. The sixth crisis is more severe because all the things that have been swept under the rug in the passion of capital inflows come to the fore: overexposure, excessive shortening of maturities, bankrupt banking systems and more.

- *How do crises happen?* We need a situation where there is real room for a difference of opinion. On one hand and on the other, true...but. In such a situation there is an appearance of calm, daily life goes on, nobody attacks and those who predict the demise of the currency are proven wrong by the continued large inflows of capital and the steady flow of good news provided by the able interior decorators. There are always stories about reform, privatization, new measures. The fact that there is something basically wrong, say a bust banking system or a huge deficit does not get to dominate the scene. Then, from one minute to the next, something big happens-- a devaluation that is too small or betting away all the reserves. In no time all the good stories are forgotten and markets shift to worst case scenarios. All of a sudden the question is how much of a meltdown and all the things that must happen before one single penny goes back to that country.
- *Avoid vulnerability in the first place.* Good macroeconomic management, including, financial deregulation and supervision, does not try to get the maximum out of the economy. It avoids using maximally the real exchange rate to achieve disinflation, it avoids getting a maximum of foreign capital on absurdly short maturity, it avoids drawing hard lines in the sand regarding exchange rates, it keeps free the room for interest rates to be raised, it avoids a budget easing in a situation of large deficits and high private foreign debt, it does not gamble the reserves away. Good macro management leaves a bit of room on every front and offers plenty of transparency. That way everybody understands that there is no problem and that policy can move to respond to emerging difficulties. As a result, like Chile, the country is so awfully dull that no speculator will waste any time on it.
- *Until you step in, you won't know how deep a puddle is.* Thailand and Mexico before surprised by the extent of meltdown. Part of the story is that seemingly few lenders and policy makers look at the size and maturity of external debts. The current account ultimately is not the only or even the dominant issue. The key question is whether there are \$30 or 40 billion of debts that suddenly risk defaulting. That moves the discussion from a financing of the current account to an open-ended funding crisis.
- *Who lent the money?* A financial problem gets to be really interesting only if the situation is highly leveraged so that, in the end, we could have really massive movements in exchange rates and asset prices. That is impossible unless the country has both a very large current account deficit and large and liquid liabilities. So who is on the other side? In Thailand's case there is no doubt, Japanese banks. They need to make money, they have no idea what is risk is as demonstrated by the fact that they have lent money into every losing proposition of the past 15 years.

The lenders and their supervisors deserve part of the blame. Is there anything wrong with summing up the external debt, and especially its denomination and maturity?

- *Don't fight, float.* Central banks simply have no chance of fighting off speculators, even using capital controls. Central banks cannot keep high interest rates forever, they do not have unlimited reserves, they do not have vast political space. In the end they will cave in and that encourages the speculators to hang around. That is far more the case when the currency can go only one way, down. The average of flat and down is down! Moreover,

if there is a chance of a bigger meltdown because reserves have been depleted already and a vast external debt might not be rolled over, the very attempt of staging a fight makes the extent of meltdown larger. In turn, that increases the interest speculators (investors as they are euphemistically called) will take in the situation. They are right, the central bank is wrong.

When the time comes for letting the rate go, because a lot of damage will already have happened, a discrete devaluation is a very bad idea. What is politically acceptable-- in an environment where ministers have declared for months that nothing is wrong and nothing will be done, 10 or 15 percent is rarely the right answer and more nearly an invitation for speculators to kick the door and see whether there is more to come. Float and let the market find its own support even if that is bad for inflation; in hindsight, inflation is the least problem that such a country will experience.

- *Don't trust policy maker to do the right thing. They are more stubborn gamblers than you think.* The fond expectation is invariably that policy makers cannot be *that* stupid. Surely they understand what is going on, they surely must be about to reveal a major IMF program, a bank clean up, a transition to floating . Not true, they persist in their mistake. The same misconceptions that got them into trouble stay with them; they will deny reality, find another way, seek vindication. Only when they get kicked out-- i.e. the system recognizes that it screwed up and is reaching for orthodoxy, do you get the deep changes. The people who screw up are rarely the ones that preside over the work out and upturn.
- *The IMF waits (impatiently) until it is called on to the scene.* It is reasonable to think that after Mexico and all the talk about crisis avoidance and enhanced surveillance we live in a better world; crises just won't happen anymore because countries won't be allowed to get that close to the stuff. Rubbish. The IMF knew about Mexico and did nothing, just as our Treasury, and it knew about Thailand and did nothing. Nothing in the sense of making public serious misgivings about the current account deficit, the deeply damaged banking system or the large short-dated and uncovered foreign loan positions.

The IMF should not be blamed: hospitals don't drive ambulances around to pick up clients for forced hospitalization, they wait with an emergency room and (one assumes) rolling 1st class reservations. The IMF should, however, post notices that read: don't believe a word about surveillance, it means nothing. We have a list of sick countries, but we can't tell you about it. In the meantime. no doubt. the IMF keeps a careful record of the warnings and admonitions issued to officials in the trouble countries. No doubt, Brazil must be getting its daily notice.

- *Contagion is always an issue.* If every crisis were exactly as the preceding one, they would all happen much earlier. There is always something new including just how long a country can hang in there until something unexpected happens and is just the straw or the ton of bricks that breaks the camel's back. The extra is always about some myth being dispelled. For example, large reserves are an effective defense: after the UK in 1992 that was no longer there, after Thailand one takes an interest in forward positions. Another myth was that Asian economies are different, now they are more nearly all the same. Or that deficits are okay when they reflect investment, or that large borrowing is not a

problem if it is private. Anytime a myth is busted, the screen search is on for parallel cases. Asian contagion is of that kind and vastly over done in the cases of Malaysia and Indonesia though not the Philippines. In Latin America the issue will return when Brazil has its accident and Argentina stands in the firing line.

- *It's not over until the fat Lady sings* . What Yogi Berra said of opera also applies to currency operettas. Until the IMF is in with a very traditional program-- budget, flexibilized currency, bank work out and monetary program-- there is no reason to expect stabilization. Once a currency gets seriously under attack it will stay in meltdown mode until the full treatment is applied. Between the IMF team arriving and the full reality check there is always a difficult moment-- politics won't allow this or that. Go right to the end of the book: the IMF program will be accepted, the currency stabilizes, the stock market picks up. The only question is just how much of a financial devastation and growth set back has happened on the way.
- *Who is Next?* Is so-and-so another Mexico or Thailand. The immediate response in the aftermath of Thailand going on the ropes was regional. The Philippines first, Malaysia, Indonesia and some knocks on the door in Singapore. Korea, of course, was already in the tank. And then there was an ever so gentle look at Latin America, Brazil most prominently, Peru, Mexico and Argentina not to speak of Venezuela or Colombia. Nothing has come of that yet.

But Brazil remains a very likely candidate: its current account deficit is the largest, absolutely, of any emerging market economy. Of course, Brazil is among the largest emerging markets so that scaling is important. That helps, but the current account as a share of GDP is in the 4 to 5 percent range even with increasing trade restrictions and slow growth. the currency is overvalued by at least 25 percent. The story that nothing can happen because low inflation is essential for the reelection of the President in fall 1998 and no accident to the currency is essential to low inflation is flawed. Brazil is just like the Philippines: rather than defend the currency with high rates and a risk to growth and balance sheets, under attack and after some reserve losses Brazil will just float. the currency will go down 15 or 20 percent, no big deal. Once the problem is off the table, the President will stand, as good a chance of getting reelected. In any event, by the middle of next year the market will ask what happens after the election.... currency realignment? Better to get that done early. An attack focuses the mind: The man who says something is impossible is interrupted by someone who just did it.

Vulnerability as the Basic Cause

Over and over again, officials in the region protest : "we are not like Latin America, all this cannot be happening". Of course, Asia is just like Latin America. Mexico, too, had a balanced budget in 1994/95, and had modernized, and had little inflation. Just like Asia, Mexico had gambled in foreign exchange and took a big hit.

The Asian crisis is not a surprise. Two years ago, MIT's Paul Krugman painted a very unflattering picture of Asia, foreshadowing the end of the miracle. He noted that much of Asian success was not productivity growth, skills and governance but rather Stalinist capital

accumulation (ouch! That hurt). He predicted that consumption would pick up and growth would go away. Of course, that was a long term prediction, but it was nevertheless a strong point to make.

Krugman's predictions should have invited a fresh look at the Asian economies as they were in the midst of plunging into the world capital market where money was slushing around looking for late hour takers. And they all helped themselves to build money temples, commodity businesses like chips and automobiles or just enjoy plain consumption from Gucci to BMW. Frenetically, Asia's skyline changed to reveal the great banking temples of Bangkok and Jakarta or any other capital city. Asia was pigging out. Anyone who had seen financial crises in Scandinavia, the US or Latin America could see the handwriting on the wall, more so if they paid attention to the role of banking systems as the link between world capital markets and local real estate and consumer finance.

The key word in understanding the transmission of the crisis is *vulnerability*. Countries that run large current account deficits need a steady supply of fresh loans. They become vulnerable if they are financed from day to day, more so if an impaired banking system makes it tricky to raise interest rates in defense of the currency. Similarly, for countries that have allowed a large, short term dollar exposure of banks or corporations who have taken advantage of low world rates and financial liberalization to import money en masse. The exposure is short term and therefore needs to be rolled by the week or month. Adverse events lead in no time to a funding crisis: debt is not rolled over, funds are pulled out just as in a bank run and that process puts the entire economy in jeopardy because it is plain hard to come up with \$50 billion in the late afternoon. Finally, countries that have allowed bank to go unsupervised and undercapitalized risk vulnerability because when banks come under suspicion, the bank run is straight into foreign exchange simply because there are no other assets. Asia has done all of the above and the exceptions are few.

Table 3 External Indicators						
(1996 data)						
	Korea	Malaysi a	Philippi nes	Indonesi a	Thailan d	HK
Budget	-1.8	-0.5	-0.9	0	1.5	1.3
Curr. Acc't	-4.9	-6.4	-2.9	-3.4	-7.4	1.9
External Debt	20.3	38.7	62.0	52.7	50.4	n.a
Short Term Debt	360	76	196	181	164	n.a.

Credit Rating	A1	A1	Ba1	Baa3	A3	n.a.
Note: All numbers as a share of GDP, except short term debt plus amortization as a share of reserves and credit rating.						
Source: JPMorgan						

In fact, a striking exception is precisely Hong Kong. There was a real estate problem and exposure to competitive depreciation on the part of competing South East Asia. But even so, the currency held up. The reason is that banks were extremely well supervised and well provisioned. Of course, they took a hit on their investments but they are still there as is the currency.

The central role of the banks and their sudden demise deserves special comment. In the late 1980s the US suffered a banking crisis. In Massachusetts, in the aftermath of a bank-financed real estate boom and bust, 70 banks were closed. In a post-mortem, the Federal Reserve Bank of Boston had some interesting conclusions. A year before being closed, virtually all 70 banks were well provisioned in terms of capital – they were good banks. More strikingly, almost two thirds of the banks that were closed died within a single quarter. When real estate meets banks assume the worst and in no time. Asia has reenacted that experience.

Malaysia stands out as prudent: the very large current account deficit, in itself a problem, was much less so because it was financed by direct investment rather than hot money. At the other end, Thailand did everything wrong as did Korea: large current account deficits, large short term exposure, and terrible banks. That produces the ingredients for sudden death as we have witnessed, in fact. Korea is especially interesting in its mismanagement: the country was obsessively focussed on keeping foreign money out: no direct investment, no investment in the stock market, no foreign purchases of high yield Korean bonds. Instead they allowed their merchant banks to borrow abroad to invest in Thailand and buy Brazilian and Russian Brady bonds. Totally mind boggling, but that is exactly what happened. Japan, even though it has not suffered an external attack, is no different: banks that made their losses in real exchange and stocks are being kept in business even though they are threatening to economic prosperity.

Contamination as the Mechanism

Conspiracy theories would seem to work so well—New York financiers have a grand design—they want to destroy Asia, the great competitor. They find the weakest link and break it and they go on, one after the other, forcing Tigers to their knees. A more plausible story has to do with the mechanics of foreign investment by Emerging Market Funds and bank lending to Asia.

Thailand was an obvious problem, as everybody admits, for well over a year. The real estate crisis had gotten underway and made the bank look back. The fall in export prices, chips and all, had made a large external deficit worse. Staying with the dollar on a big upswing caused a major

loss in competitiveness with possibly more to come, over and above steep wage increases at home. To keep money coming to finance the Ponzi game and hold the exchange rate, interest rates had to go up and reward foreign lenders for the risk, but that made real estate and banks even worse. To keep banks alive, interest rates had to go down. The government could not have it both ways. They cut rates, made it free to speculate against the currency and that is what happened. Not just NY speculators but a large part of the Thai borrowers who covered their dollar positions at the expense of the Thai authorities. Reserves ran out and the rest is history. The story then starts with a government getting itself into a corner, taking the soft option and crashing. Mismanagement of reserves made everything much worse.

If we accept that story, why the Philippines, Indonesia, Malaysia, Hong Kong and Korea? Investors looked beyond Thailand to ask whether there is genuine vulnerability elsewhere: big current account deficits, bad banks, loss of competitiveness as a result of the Thai devaluation. Were there countries that were unlikely to be able to raise interest rates because of domestic constraints and hence could not defend their currency? If so, then these exposures had suddenly moved to high risk category and needed watching or even liquidating. That is the first wave of selling. Soon it turned out that speculators were right, currencies started moving simply because there was no taste for defending them by high interest rates.

There is another mechanism at work. Emerging market funds, after Thailand and increasingly as the spectacle unfolded, experienced run offs. Investors who thought Asia was safe and easy investing had second thoughts. As funds experienced withdrawals, they had to sell off their investments in turn to pay out their investors. What to sell? Obviously the countries that were still good but already coming under suspicion, not the countries that had already tanked and might have some upside. Thus the crisis is spread automatically to those countries in the gray area of suspicion but with a chance, too, of making it. The same is true for bank lenders who must pay attention to their own credit rating. When a region goes under it deteriorates a banks' credit standing, funding cost and stock market value. As Asian loans became a negative, calling back loans is the routine response. Reducing Asian exposure became mandatory not only in the countries where debtors were already on the ropes but preemptively in the places where they might soon be and where the money could still be gotten. This is just another form of bank run, this one by the lending banks.

Of course, contamination was not limited to Asia: Russia got under pressure for the same vulnerability as did Brazil. No doubt, there is more to come. Once lenders and investors move into defensive mode they retreat from the periphery until the dust settles. After the compression of spreads and the stock booms of the past 3 years, normality is coming back with a fair dose of overshooting.

The extent of the sell-off in currencies and stock markets is extraordinary, nothing short of a fire sale where everything goes half price. That is always the case, at least in the short run, when finance is the dominant part of a crisis. Yet, even at these much reduced prices, speculators don't seem to have any appetite.

Where Is Stabilizing Speculation?

There are three reasons why, in the face of the large decline in asset prices, speculators are not rushing in for bottom fishing or to build "scavenger funds" to buy up distressed real estate as they did in the US in the aftermath of our banking crisis. The first reason is that there are possibly more dominos to come. That was the case of Korea until a month ago and it remains a possibility in Japan and China.

China is, of course, special. The country is very unlikely to experience an external attack: there is a current account surplus, no short term debt and massive exchange control. None of the overborrowing and the short maturities that put other countries in the hot seat. But China does have a huge banking problem, most likely the worst in Asia. The way China could get into trouble is with an internal bank run, the kind of thing that is under way in Japan. If the Chinese public starts fearing for their deposits and try to pull the money out of the banks, what happens next?

Note, the Chinese at this point might just want *their* money, renminbi not dollars. They can have their money, no problem. The benign interpretation is that the government prints enough money or in fact has it already in the basement of every bank. It pays out people until everybody realizes there is no problem. End of story. But if all this is bungled, becomes a big riot and so on, then investment in Asia will all of a sudden look even less promising than now. Any sign of China getting into political problems is a dramatic downer for Asian investment.

There are softer versions of the China problem. For example, Chinese growth has been slowing down. Recession in the region, including Japan, reduced exports and the competitive devaluation of everybody makes the problem worse. So when will China devalue, the markets ask? And if China does, will there be second helpings for everyone else? The question is enough to cool off any enthusiasm for Asian bottom fishing.

The other problem, real and big, is Japan. There is a banking crisis and a growth crisis. Both are totally mismanaged with the result that Japan is slipping into recession. Just how bad the recession will be, including a further collapse of stocks and, as a result, quick and sudden death of banks is wide open. Japan is dragging Asia down, it puts in question the export-led recovery strategy prescribed by the IMF for each of the trouble countries. Japan's crisis does so in two ways. First, Japan is an important market and it is clearly shrinking. That means less exports and less of an increase in current account surpluses for all the IMF cases. Second, the Japanese demise pushes down the Yen and with it all Asian currencies. Bargain hunters must not buy too early, the prices are getting better and better! Finally, the Asian onslaught of exports to the US risks an outright crisis of free trade. The US administration is firmly committed to free trade and so is much of the public. But if Asian mismanagement becomes a trade crisis in the US, protectionist talk is certain. Investors will view that as a negative for Asia and another reason to hold off. Contamination is a critical obstacle to stabilizing speculation. It will continue until Japan gets its act together which does not seem to be around the corner.

There are two other reasons why investors will hold off. First there is obviously the dramatic lack of transparency. Investors simply will not know what they are buying or how solvent their loan clients are. The idea of reliable accounts does not exist, not in Japan as the last few weeks make clear, not in Korea nor anywhere else. Perhaps investors did not appreciate that fact before the crisis and it did not matter much because everything was smooth sailing. But now, who wants to buy a corpse rather than a live body? Asians might reply that transparent, audited accounts are

yet another manifestation of "marketism", just like litigation or due diligence. Perhaps that is the case, but trust investors to take it seriously if only because their clients on the other side are now asking hard questions.

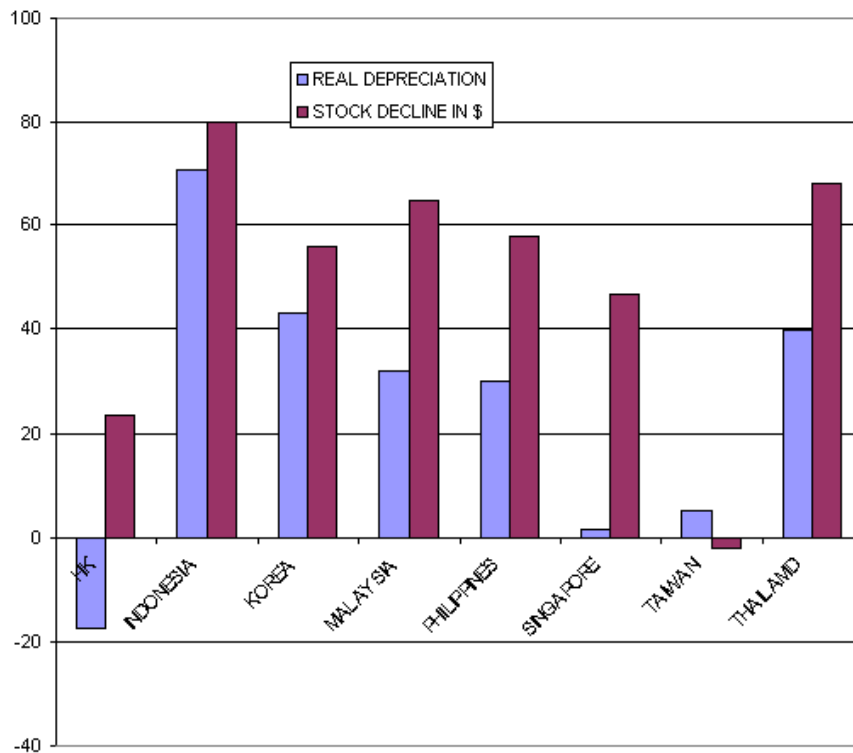
The other obstacle to an early and enthusiastic return of investors is politics. We have to see just how well Asian politics takes to IMF programs. In Korea the uproar is underway—the IMF program is called a US attempt to buy up Korea at bargain prices. In Indonesia it is expected to bring down Suharto, though not the system. Dr Mahtir is busily blaming speculators to try and extricate his own dubious commitment to a world of mega projects. The more politics is in the street and noisy, with IMF programs in question or even suspended, the more reason to stay away.

But politics is also a factor in deciding who pays the adjustment burden left after this crisis. Are bank owners balked out and not only depositors? Do Suharto's children get to keep their toys. Will the Japanese bureaucrats pay for the damaged banks and make them good investments or do bankers get hair cuts? With these questions unanswered, investors will hold off their return. They say they are interested, but they admit it may be premature.

THE GREAT ASIAN WHITEWASH

Everybody who is anybody is showing up at the post mortem. They all claim something very different happened here. E. Sakikabara, Mr. Yen the vice minister of MoF, has declared that the Asian events are the first crisis of global capitalism. George Soros misses no occasion to claim that the events confirm his views that capital markets have no fundamentals and resort to "strange attractors". My colleague Paul Krugman claims that *We* must try and understand this new kind of crisis and Jeff Sachs has argued vociferously that there is something new here and it needs an appropriate institutional response. Of course, there is no surprise that leaders of the hard hit Asian economies have every reason to claim that they fell prey to something unreasonable and implausible that robbed their economies of the fruit of decades of hard work and investment. Nor is there surprise in the IMF and our Treasury, having spent more than ever on bail out, to claim that it was in response to a new and different challenge to global stability. Just how new is all this?

THE GREAT ASIAN CARNAGE (PERCENT CHANGE SINCE 1996)



The answer, surely, is that there is nothing new here that separates it in a fundamental way from the 1982 debt crisis, or the Mexican crisis of 1995 or hundreds of years of international financial crises. The bankers adage is "it's not speed that kills, it's the sudden halt. This was just another instance. The exact details differ and influence the extent of disaster, but the principle is by and large the same: too much money borrowed on some set of beliefs which turns out to become invalid—stable interest rates, political continuity, never-never a devaluation, real estate can only go up, growth will never slow down or whatever the story is. As the underlying assumption is pulled away, the debt looks like a house of cards and because it is both short term and dollar denominated without an offsetting central bank reserve, collapse of the currency is inevitable. Stabilizing speculation is absent because credit worthiness cannot readily be established nor is there assurance of exactly what role government will play in bailing out or supporting default. The same story that goes for the crash of a real estate bubble, or a stock market bubble goes just as much for a country bubble.

It helps at the outset to dispel one notion. Even before the crisis, an argument started about productivity growth in Asia and the question the high rates of investment were particularly productive. That question is an issue of ongoing research with the early rendition which was highly pessimistic of productivity growth now somewhat in question. The crisis has relatively little to do with decades of investment. Those decades of abstinence and capital accumulation translated into growth and rising standards of living. And even if the current crisis is very bad, it will hardly make a dent in the accomplishments of 30 years of high growth or a near-seven fold increase in GDP.

The lead-up to the current crisis is surely this collection of facts:

- Financial liberalization, partial and poorly regulated and supervised, led to a rapid accumulation of short term foreign currency denominated liabilities. These were held by banks and corporations, with details differing across countries. Within the short period from end of 1995 to June 1997, Asia accumulated an extra \$83 billion dollars in debt or a 28 percent increase in indebtedness. Of this debt, more than 62 percent had a maturity of less than 3 months.
- The 1996 world slowdown had created a sell off in the area of electronics with resulting slow export growth and excess capacity. This was perceived as a weakening factor.
- The appreciation of the dollar from late 1995 to 1997 placed dollar pegging countries in the position of an automatic loss in competitiveness.
- Credit was available on the most generous terms. There was a worldwide compression of yield spreads and reduced credit rationing and standards.

Table 4 Bank lending to Emerging Markets					
Region	Total (\$)	Maturity <1 year (%)	Lender (%) Europe	Japan	N. America
All	745	58	52	19	16
Asia	390	62	44	32	10
Korea	100	68			
Indonesia	59	59			
Thailand	70	66			
L. America	251	52	58	6	28
Brazil	71	62			
Argentina	44	54			
E. Europe	110	51	82	5	4
Russia	69	55			

The rest is the detail of how the crisis got going, propagated, and got out of hand. Surely the starting point was Thailand where an increased budget deficit worsened the external balance

even as a real estate boom came to an end. The government was caught between the need for high interest rates (i.e. Singapore level) to keep the currency in line and low interest rates to keep the banks and finance companies alive. Such a situation cannot last and, in the end both the currency and the banks will go. Speculators and observers understood and commented widely on this fact even a year before it came to the blow out.

The central bank made things worse. It lowered rates below Singapore so that it effectively created a free carry. Speculators took up the offer and the central bank took the bet in the forward market. All reserves were lost and the rest is history. When reserves were gone but balance sheets were unhedged, a currency collapse resulted which in turn produced the prospect bankruptcies and default which evidently led to a no roll-over situation. The first crisis had happened. If policy response had been vigorous—credit clean up, high interest rates, budget tightening—the crisis might have ended there.

The continuation comes from a variety of channels starting with the effect of one country's devaluation on another's competitiveness, the preemptive selling on the assumption of contagion, the fact that there were banking problems everywhere. And the more countries went under, the stronger the presumption that the next one would, too. A central fact in this transmission is the working assumption that once exchange rates move, banks or companies with balance sheet exposure from dollar denominated liabilities risk bankruptcy. That environment bars stabilizing speculation and thus makes the foreign exchange market a one-way street. Policy failure made the crisis worse. Reserves were gambled away to near-zero, lack of supervision and regulation left a weak banking system thus amplifying the risks of a currency move.

Asia had experienced a bubble driven by cheap money or what Argentina calls *plata dulce*, nothing more or less than that. Any bubble in stocks, real estate or a country's prosperity is just waiting for a shift of assumptions and the resulting run. In 1982 it was the US fight against inflation that disrupted the debt finance algebra and brought on moratoria and forced lending. In Mexico's case it was the unexpected and almost unimaginable devaluation which was meant to restore growth in an economy that had become overvalued. In Thailand it was cutting rates below world levels. With the dynamite in place, a good match will do the rest. And just the same will happen sooner or later in the US stock market, just another bubble waiting for the shift in assumptions. If the possibility of a rate is the working assumption, the resumption of inflation will be the match.

What are the lessons to be drawn? A first one is policies to limit and prevent crisis. Anything that contains bubbles without sacrificing a decentralized market economy will do. Anything that prevents excessive leverage of central players is critical. Countries should be required, if they want IMF support, to have independently audited certification that their banks are well capitalized. There ought to be a national "value at risk" calculation that assesses how the maturity and currency denomination of liabilities interacts with potential shocks to create significant risks. The routine presentation of these stress tests ought to become a significant criterion for lenders and investors. We have had bubbles and crashes forever, and sovereign loan problems. We are unlikely to abolish them because the little extra yield makes all the difference. But we surely can make it harder to have mega collapses.

There is nothing new in this crisis except this. Everybody assumes that Latinos have collapses, Asians do not. One should have paid, of course, attention to Japan which started it all. But in this

instance Asians were crowding the Louis Vuitton and Gucci shops around the world just as Latinos had when it was their turn to have *plata dulce*.

JAPAN'S CRISIS OVERSHADOWS ASIAN NORMALIZATION

In Tokyo, everybody is waiting for "Big Bang". They might be in for a surprise, big bang might be the collapse of the Japanese economy rather than a new age of competitive finance. Surely the greatest paradox today is that one of the richest countries in the world, Japan, is flirting with bankruptcy. Its banks are being downgraded, its budget deficit is alarmingly large, its debt is huge and if the unfunded pension liabilities are included, reaches levels of above 200 percent of GDP. One might even say at in financial terms, Indonesia looks good compared to Japan. The Japanese say their plight is not real: threat work hard, they are better educated than anyone else, they have technology, they are the lenders to the whole world – how can they be bust? All that could have been said of the Us in 1929 when President Hoover and the Federal Reserve pursued deeply misconceived policies that plunged the US and the world into the Great Depression.

Japan today is no different: There must be no question that Japan is teetering on the very verge of 1930s style collapse of financial institutions, confidence and economic activity. All the right things are "very difficult", not really understood and certainly not believed. Having preached to the US for more than a decade that deficits are bad, that Japan is right and free market pursuit of prosperity is inferior to conformism and a managed economy, Japan's public and most surely its sclerotic policy making process just cannot jump over its own shadows. Japan is trapped. If everything goes well, the country will just putter along with near zero growth. If something goes wrong, and it does not take much as we saw 2 months ago, it will go over the cliff and pull down the Asian region in the process.

True, there is a 1997 supplementary budget which adds some demand—less than the regular budget took away. But then there is the regular 1998 budget now before the Diet which offers new fiscal restraint but that, we are told will be offset by new expansion in the supplementary 1998 budget which will come the month later. Sorry all this is confusing, but that is Japan where face saving and pretense are more important than the results. Cut through the charade and the truth is that if we are lucky there will be a one quarter of one percent stimulus this year on the fiscal side. That is not enough to offset the impact of deteriorating confidence and falling bank loans as the financial system tries to reach minimum world capital standards. Japan is the weakest link in the world economy and Asia has the misfortune of being next door.

What should Japan do? Three steps are essential. First and foremost, a huge tax cut, say 3 percent of GDP. Small tax cuts do nothing, there is now a need to take a big leap forward, create a forceful expansion in demand, output and employment and start rebuilding confidence. When confidence is eroding, nickel and dime fiscal policy make the budget worse without making the economy better. Second, Japan must immediately do a deep clean up of its financial system. This is vastly different from tinkering with accounting rules or setting aside money to pay depositors of failed banks. It means taking out the bad loans and making banks liquid and eager lenders. nonperforming loans are somewhere between 12 and 15 percent of GDP and presumably rising. Years of bad loans are coming to roost, no bad loan was ever refused. Cleaning up the banks costs a lot of budget money, not doing it now will cost far more later. Third, Japan must

deregulate and open up pervasively. The country is like in-grown toenails, regulated to the hilt by a bureaucracy that has the last word on literally any . Deregulation means getting rid of bureaucrats, laws and regulations do not reverse the state of affairs. As long as the bureaucrats are in place they will do what they have been appointed to do——op people from pursuing their market interests or conspire with them to conceal bankruptcy and misfeasance. Japan needs a vigorous market economy.

The old model is dead, over the next two decades the government needs a gigantic amount of money to meet its liabilities. More taxes can't deliver that, they would merely crash the economy as we saw last year. The right answer is a vast expansion of tax payers and economic activity—the supply side. That is what the US did in the early 1980s—pay for bank clean up and big deficits by supply side economics. Patently it has worked since the Us enjoys both full employment and a balanced budget and in the face of an acute labor shortage can even afford to do such controversial things as abolishing welfare. Just as sclerotic Europe, Japan must now adopt the US model. Since that is counter cultural don't wait for it, but then also don't expect that Japan will surprise with a sudden rebound. Not in this century and not for a long time beyond.

Asia is building its recovery on export led growth. Mega devaluation and recession translate into exports readily available as well as competitive. The more Japan's economy is flat on its back, the larger the Asian economy's problem to get back on its feet. Japan's size as a market makes that point quite obvious. The bad news, of course, is this. Asia needs to resume growth one way or the other. The more sick Japan, the more depreciated the Asian currencies will have to be. The more sick Japan, the more Asia and Japan will compete in running huge trade surplus toward Europe and the US. There will surely be a strong message from the advanced countries: no thank you. Trade conflict is a live possibility.

The Asian discussion has focussed excessively on the US role in the bailouts— dial

1-800- BAILOUT and was the IMF right or wrong and what should the programs look like. The most immediate answer for the region is a prosperous Japan. That is in Japan's own interest and it is paramount for the region. Why don't Asian leaders get the message and tell Japan: Shape up and start being part of the solution rather than complicating the problem.

WILL CHINA DEVALUE?

If China devalues, without question, the Asian situation would take a change for the worse. There would be a further round of currency depreciation and stock market decline, spill over to Japan would be significant and even to Europe and the US. All this is highly unlikely. Here is the list of considerations.

Table 5 Chinese Indicators				
	1990-95	1996	1997	1998
Growth	10.6	9.6	8.8	7.5

Investment	32.0	35.6	35.8	n.a
Curr. Acc't	1.2	0.9	2.5	n.a.
Budget	-2.0	-1.5	-1.5	n.a
Source: IMF				

The argument for a devaluation is straight forward. China's competitors in world trade have had a large depreciation. Accordingly, China is now less competitive with the implication that growth will come off just at a time where high growth is required to tackle the essential issue of enterprise restructuring. More than 100 million workers need to find new jobs as inefficient operations are closed down. How could this be accomplished without growth? And how would there be growth without a boost from depreciation. Moreover, this is not just a question of the growth necessary for reconstruction, there is also in this view a need to alleviate the pervasive excess capacity in China's industry and the rapid accumulation of inventory. One more reason to seek relief via devaluation.

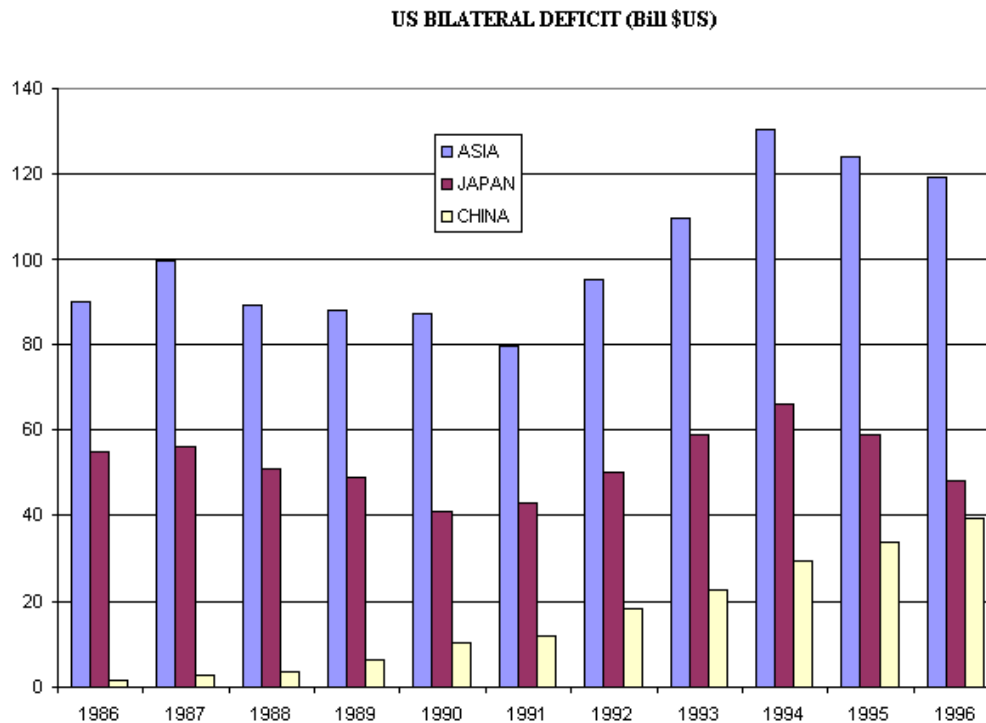
But there are powerful arguments on the other side and they are very likely to carry the day. First and foremost, China does not have the external vulnerability common to many other Asian economies. International reserves are nearly three times the commercial bank debt and 6 times the size of short term external liabilities. Moreover, the current account is in surplus or at best near zero. There are strict capital controls as convertibility only applies to current account transactions.

In the same line, Zhu Ronji is scheduled to be the next Prime minister and as such as little interest in a career-stopper devaluation. Even once in office, his concern must be with consolidating power, not a dubious exercise in financial instability. He must also recognize, surely, that competitive devaluation risks other costs. The US bilateral deficit with Asia is growing sternly. It is one thing that a beaten up country like Thailand or Korea seeks export-led growth. But why should the US Congress accept that China (or Japan) join in by adding to the export avalanche? This is more the case since China already dies run a huge bilateral surplus with the US. The US would most definitely react by not renewing most favored nation treatment next June and that is a costly problem. Entry into the WTO might be prejudiced.

It is also important to understand that the current real depreciation of Asian crisis economies is not the last word. Either by inflation or nominal appreciation a good part of the real depreciation will be going away. Hence a strategy of holding out offers plausible opportunity to assess the damage and then make decisions.

China must also must recognize that as a large actor, it invites almost inevitably a reaction from other countries. If the whole Asian crisis stated with the earlier Chinese devaluation (in the context of unifying rates to accomplish current account convertibility), then a Chinese devaluation forces second helpings from everyone else. And if so, what comes next? China would risk being drawn into the same downward spiral that others have suffered. It might not be at the hands of foreign speculators but surely at home uncertainty about inflation and the

solvency of banks would quickly turn the situation into bank runs and unrest.



Arguing that China won't devalue is a far cry from believing that there are no problems. More likely than not, growth won't reach the 7-9 percent range now forecast, budget problems will get bigger and the politics of enterprise reform will be tough. A big public spending boost to GDP will be tempting but that endangers financial stability.

And if there is a need for one more argument, it is surely the Hong Kong issue. A significant Chinese devaluation—a small one is not worth the trouble—would surely be an extraordinary test for Hong Kong. The place belongs to China, what sense is there to try and do experiments that can only undermine financial stability in the mainland.
